

Who Bears Withholding Tax When a Settlement of Litigation Agreement Is Silent?

Tax Update

WRITTEN BY

Howard S. Goldberg | Lisa B. Petkun

IF A SETTLEMENT AGREEMENT IS SILENT, A DEFENDANT IS NOT REQUIRED TO ‘GROSS UP’ THE SETTLEMENT, AND THE PLAINTIFF WILL SUFFER THE WITHHOLDING TAX BURDEN.

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What happens when settling parties agree that the defendant will pay a specific sum to the plaintiff, and the defendant discovers later that withholding of taxes is required? Does the defendant withhold and pay the net amount to the plaintiff, or is the defendant required to gross up the payment, such that the plaintiff receives the agreed-upon amount net of taxes?

The U.S. District Court for the Eastern District of Michigan ruled on this question in *I.E.E. International Electronics & Engineering, S.A. v. TK Holdings Inc.* (E.D. Mich. July 27, 2015). In *I.E.E.*, the parties reached a settlement at a conference conducted by the district court. However, the parties later reached an impasse on account of a withholding tax issue when they sought to memorialize their settlement in a written agreement. The oral settlement that they reached called for the defendant, Takata A.G., to pay I.E.E. \$1.1 million, but there was no discussion with respect to withholding taxes. After the conference, Takata was informed by its tax advisors that the contemplated payment from a German corporation to a Luxembourg entity was subject to tax withholding under German law. The plaintiffs took issue with the defendant’s stated intention to withhold the German taxes.

The court first observed that the parties failed to anticipate the possibility that withholding taxes might be payable. It then determined that the parties’ silence on this issue could not be construed as evidencing their tacit agreement that the defendants would pay the full \$1.1 million and also would shoulder the burden of the withholding tax. Because there was mutual unawareness of the withholding tax issue, the court was required to determine how the unanticipated tax obligation should be handled in the settlement agreement. There were two bases for the court’s conclusion that the tax obligation rested solely on the plaintiff.

First, it cited the settled principle of contract interpretation that the terms of an agreement should be presumed to comply with applicable law. German law required withholding tax, and, therefore, the defendants were required to withhold the tax.

Second, the court cited and relied on three cases in which the parties had reached a settlement that obligated the defendant to pay the plaintiff a specific sum, but where the parties had not considered the tax consequences, specifically tax withholding. The courts in all three cases were called on to determine whether the defendant was required to gross up the settlement payment or whether the burden of the tax would be borne by the plaintiff. The courts reached the same result, namely that a settlement agreement's silence with regard to tax consequences leaves the paying party free to withhold taxes from its settlement.

The court in *I.E.E.* also rejected the plaintiffs' suggestion that the defendants should ignore the tax withholding and let the plaintiffs be solely responsible for their tax liability, taking cognizance of the defendants' assertion that this course of action would not comport with German law. The three cases relied on by the *I.E.E.* court were:

- *International Union, United Automobile Aerospace & Agricultural Workers v. Hydro Automotive Structures North America, Inc.*, 2015 WL 630457 (W.D. Mich. 2015), in which the court rejected the plaintiffs' contention in a class action settlement that the silence in the settlement agreement required the defendants to gross up the payment
- *Powertech Tech. Inc. v. Tessera, Inc.*, 2014 WL 2538973 (N.D. Cal. 2015), in which the case law was viewed as establishing that, when there is a withholding requirement imposed on one party, that party must comply with the requirement as it applies to settlement payments and that silence as to tax withholding leads to a presumption that taxes are levied on the total settlement amount agreed upon
- *Josifivich v. Secure Computing Corp.*, 2009-2 U.S. T.C. (CCH) P50, 543 (D. N.J. 2009), where a settlement agreement regarding unpaid commissions and employment discrimination was silent concerning the withholding of employment taxes, and the court held that it would not alter the terms of the voluntary settlement agreement and require the defendant to pay more because the plaintiff was dissatisfied with the anticipated tax consequences of the agreement.

In applying the cases to the instant situation, the *I.E.E.* court held as follows:

Defendants may comply with the withholding requirements of German tax law without "grossing up" their payment to Plaintiffs to account to and offset this tax withholding. As the courts have recognized, the withholding of taxes is a natural and wholly foreseeable consequence of a payment made by one party to another pursuant to a settlement agreement, and the parties here were free to allocate this withholding burden among themselves as they negotiated their settlement. Having failed to address this issue, the parties are subject to the presumption that "each side has to bear the tax consequences" attendant to the performance of their obligations under the settlement agreement. Although Plaintiffs suggest that Defendants should simply pay the entire \$1.1 million settlement amount and leave it to Plaintiffs to fulfill any obligations imposed by the pertinent tax authorities, Defendants state without contradiction that this proposed course of action would not comport with German law, and that they have no choice but to withhold taxes from their settlement payment. Thus, if Defendants were required to pay the full \$1.1 million settlement amount to Plaintiffs and **also** make the payment demanded by the German taxing authorities, this would result in payments by Defendants in excess of the \$1.1 million figure they agreed to in the parties' settlement. Moreover, Plaintiffs would obtain **both** the full value of Defendants' \$1.1 million settlement payment **and** the economic benefit derived from Defendants' satisfaction of the tax obligation owed by the parties to the German taxing authorities as a result of their agreed-upon settlement transaction.

As observed in above-cited cases, silence in a settlement agreement as to the tax consequences of payments surely does not warrant such a reapportionment of the parties' benefits and burdens under their agreement.

Rather, if Plaintiffs wished to ensure that they would receive a full \$1.1 million settlement payment without regard to any tax consequences of the parties' agreed-upon transaction, they should have negotiated for such a term in the parties' settlement agreement. Because they did not, the Court declines to alter the terms of a settlement reached in hard-fought, arms-length negotiations among sophisticated parties, each of which was represented by highly skilled counsel and had ample opportunity to consider the tax consequences of the opposing party's settlement proposals. By resort to the principles articulated in the pertinent case law, the Court construes the parties' settlement here as calling for Defendants to withhold taxes from their \$1.1 million payment to Plaintiffs in accordance with German tax law, without any obligation for Defendants to "gross up" its payment to ensure that Plaintiffs receive the full \$1.1 million settlement amount. [Citations omitted.]

Pepper Takeaway

The tax consequences of a settlement should be addressed in the settlement agreement, particularly where withholding tax is involved. If the agreement is silent, *I.E.E.*, and the cases it cited, show that the plaintiff will suffer the withholding tax burden. The court in *I.E.E.* stated conclusively that the defendant is not required to gross up the settlement for the plaintiff because that would increase the amount of the agreed-upon settlement.

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